401(k) AFTER-TAX CONTRIBUTIONS AND DISTRIBUTIONS

Contributing to an after-tax account in a 401(k) plan is one way to build a source of retirement income with little tax impact for flexibility when needed.

Many 401(k) plan participants are surprised to learn that their plans might allow them to personally make after-tax contributions to their 401(k) plans in addition to making pre-tax salary deferrals and, potentially, designated Roth contributions. Since taxes are paid up front, contributing to an after-tax account in a 401(k) plan is one way to build a source of retirement income with little tax impact when needed. An after-tax account can also lead to tax-efficient Roth conversions and further tax diversification strategies.

What are after-tax contributions?

In a 401(k) plan, standard after-tax contributions are amounts that a plan participant elects to set aside from his or her pay after the payroll department withholds taxes. The plan administrator deposits the after-tax contributions in a separate account within the 401(k) plan, where the amounts have the potential to grow on a tax-deferred basis. The amount of contributions and their associated earnings or losses must be separately tracked in order to optimize a tax efficient return of the account value. In contrast, pre-tax employee salary deferrals are withheld and deposited to a separate account in the plan before taxes have been removed. While a 401(k) participant also may defer from his or her pay amounts as designated Roth contributions, which are also after-tax, they are distinct from standard after-tax contributions, and subject to different contribution and distribution rules. Plan participants should check their plan account statements for the various categories of contribution types.

Standard after-tax contributions and accounts in defined contribution plans date back to the late 1950s, but lost attention when the ability to make pre-tax salary deferrals to 401(k) plans came on the scene in the early 1980s as a result of the Revenue Act of 1978. Today, plan sponsors have the ability to decide whether they want to include a standard after-tax contribution feature in their plans. Between 25 and 30 percent of today's 401(k) plans still offer participants the ability to make employee after-tax contributions other than designated Roth contributions.[1]

Are participants limited in making after-tax contributions?

As with other types of contributions to a 401(k) plan, participants are limited in the amount of after-tax contributions they can contribute to their 401(k) plans. Plan sponsors must be sure to consider after-tax contributions in the testing of three contribution limits: the annual additions limit, the actual contribution percentage (ACP) test and the top-heavy determination.

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[1] Plan Sponsor Council of America, 64th Annual Survey, 2021 and Retirement Learning Center plan document database, 2022

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When determining a participant's maximum annual contribution (i.e., "annual additions limit") under Internal Revenue Code Section [IRC §415(c)], the law requires plans to consider all contribution types, including after-tax contributions, in addition to employee salary deferrals, designated Roth contributions and employer contributions. These rules currently limit a participant's annual additions for 2022 to 100 percent of compensation up to $61,000 (or $67,500 for those ages 50 and older who are making catch-up contributions). A participant's after-tax contributions are also included in the ACP test for the plan, which requires that matching and after-tax contributions in a 401(k) plan do not unduly favor highly compensated employees (HCEs) over non-HCEs. Finally, after-tax contributions are considered in the top-heavy test for the plan. If a plan is top heavy, meaning more than 60 percent of its assets are held by key employees (generally, the owners and officers of the business), then the plan must meet minimum vesting requirements and ensure provision of a minimum contribution for non-key employees. Even a safe harbor plan design does not eliminate these testing requirements for after-tax accounts.

What are the parameters for withdrawing after-tax contributions?

The provisions of the specific employer's plan document govern when amounts from a participant's after-tax account are eligible for withdrawal. In many cases, plans allow participants to access their after-tax accounts prior to reaching age 59½. Over 80 percent of all 401(k)/profit sharing plans today offer in-service distributions, which allow participants to withdraw amounts from their plan while they are still working.[2] Of the plans that offer in-service distributions, many participants may request a distribution of their after-tax account balance at any time.

For taxation purposes, distinct rules apply to withdrawals of after-tax amounts made prior to 1987 and those made after 1986. Prior to 1987, participants could withdraw their employee after-tax contributions tax-free. To limit a worker's ability to use these tax-favored arrangements for nonretirement purposes, lawmakers, through the Tax Reform Act of 1986, implemented "basis recovery rules" that apply to distributions taken from after-tax accounts after December 31, 1986. A special grandfather rule allows participants to continue to first withdraw their pre-1987 after-tax contributions that have been tracked separately on a completely tax-free basis.[3] For withdrawals of post-1986 amounts, participants must treat the recovery as a pro-rata return of basis and earnings from the after-tax account. Under these rules, the amount a participant is entitled to exclude from taxation is determined by multiplying the amount of the payment by the ratio of the participant's basis to the total value of the participant's after-tax account balance under the plan as of the date of distribution.

Pro Rata Formula for Post 1986 Withdrawals

$$\text{Amount Received} \times \frac{\text{Basis}}{\text{Account Balance}} = \text{Tax-Free Amount}$$

[2] Plan Sponsor Council of America, 64th Annual Survey, 2021 and Retirement Learning Center plan document database 2022,
[3] IRS Notice 87-13

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Example

Ann Brown received a $50,000 distribution from her retirement plan. She had $10,000 invested (basis) in the plan. Her account balance was $100,000. Applying the formula, $5,000 of the $50,000 distribution is a return of after-tax basis and $45,000 is a return of pre-tax amounts.

$$\$50{,}000 \times \frac{\$10{,}000}{\$100{,}000} = \$5{,}000$$

If the 401(k) plan has not tracked the pre-1987 and post-1986 after-tax amounts separately, but has tracked the after-tax contributions separately, the basis recovery rules apply to the entire after-tax account.

What are the portability options for an after-tax account withdrawal?

Today, plan participants have options for their 401(k) after-tax account withdrawals, but prior to 2002, after-tax contributions lacked portability as they were not eligible for rollover to another plan or to an IRA (even though their earnings were). The Economic Growth and Tax Relief Reconciliation Act of 2001 changed that by allowing employee after-tax contributions to be included in an eligible rollover distribution along with their earnings, provided the receiving plan is an IRA or a defined contribution plan that separately accounts for the amount. Consequently, if a plan participant is allowed to and elects to take a withdrawal from his or her after-tax account, he or she has the following portability options:

1) roll over the assets to a new employer's plan, if permitted by the new plan;

2) roll over the assets to a traditional IRA;

3) convert the assets in-plan to a designated Roth account or to a Roth IRA outside the plan; or

4) receive the amount in cash.

Each choice offers advantages and disadvantages. Therefore, a distribution decision should only be made after reviewing information that is fair, balanced and not misleading. Investors should consider several factors, including but not limited to the following: available investment options, fees and expenses, services, penalties, creditor protection, required minimum distributions (RMDs) and the tax treatment of employer stock.

How are rollovers of after-tax account withdrawals accomplished?

Plan participants can roll over distributions from their after-tax accounts to either a traditional IRA or a qualified retirement plan. If the participant selects an IRA rollover, he or she can move the amount directly, meaning the distribution goes immediately to the receiving IRA, or indirectly, meaning the participant receives a distribution and rolls over all or a portion of it within 60 days. The IRS views the amount rolled over indirectly as consisting first of pre-tax amounts, followed by after-tax amounts. If a participant selects a rollover of his or her after-tax account to a qualified retirement plan, it must be accomplished as a direct rollover.

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Who might consider a Roth IRA conversion of after-tax withdrawals?

Roth IRAs have several appealing features, including, but not limited to, the potential to take tax-free withdrawals and no RMDs for their owners. But some individuals are not eligible to make annual Roth IRA contributions because of income restrictions. There are no income limits that prevent a plan participant from converting eligible plan assets to a Roth IRA, however. And a participant's after-tax account in a 401(k) plan may offer a potentially tax-efficient way to accomplish a Roth IRA conversion, especially if there is a favorable after-tax contribution-to-earnings ratio. 401(k) plan participants may want to consider a Roth IRA conversion of their after-tax account if they

- Are currently ineligible to contribute to a Roth IRA because of their income level
- Have made after-tax contributions to their workplace retirement plans, especially before 1987
- Have the ability to contribute to their 401(k) plans on an after-tax basis but have not yet done so
- Have an in-service distribution option in their plans
- Would like to avoid mandatory distributions during their lifetimes with Roth IRAs
- Would like to accumulate potentially tax-free assets for their beneficiaries[4]

How is a Roth IRA conversion of after-tax withdrawals accomplished?

A Roth IRA conversion is a type of rollover. Therefore, when participants are considering a conversion, they should contemplate the pros and cons of all their distribution options (i.e., leave the assets in the plan, distribute them or roll them over to another employer's plan or IRA) by reviewing information that is fair, balanced and not misleading. Considerations for each include applicable fees and expenses, services, investment options, penalty-free withdrawals, creditor protection, RMDs and employer stock. Participants must weigh the imposition of any surrender charges or penalties that may result from the conversion as well.

A conversion to a Roth IRA that includes pre-tax dollars is a taxable event. Because of the basis recovery rules that apply to withdrawals from 401(k) after-tax accounts, a participant must consider any pre-tax amount converted as ordinary income in the year of the conversion. However, under the guidance of IRS Notice 2014-54, a plan participant can accomplish a tax-free Roth IRA conversion of an after-tax account withdrawal by directing the distributing plan administrator to 1) separate the pre-tax from the after-tax amounts; 2) directly roll over the pre-tax portion of the distribution to a traditional IRA; and 3) convert the after-tax portion of the distribution to a Roth IRA. The net effect is a tax-free traditional IRA rollover and a tax-free Roth IRA conversion.

Alternatively, a participant could consider an indirect or 60-day rollover and conversion. Under this approach, an eligible plan participant requests a withdrawal of his or her after-tax account, to which the plan administrator is required to apply the standard 20 percent federal withholding rules. Within 60 days,

[4] This only applies if the original owner or the owner and beneficiary together have held the Roth for at least five years

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the individual first rolls over the pre-tax amount (the earnings) to a traditional IRA and second converts the after-tax amount to a Roth IRA. In order to avoid any tax liability, the participant would also have to roll over an amount equal to the amount withheld for federal income tax purposes (20 percent of the pre-tax amount).

Example

Tax-free Roth IRA conversion	
Gracie has the ability to take a distribution from her 401(k) after-tax account. After considering the pros and cons of such, she decides a conversion to a Roth IRA is in her best interest. Her 401(k) plan account statement reflects the following amounts.	
Pre-1987 after-tax	$20,000
Post-1986 after-tax (including earnings of $5,000)	$30,000
Employer matching	$200,000
Profit sharing	$ 50,000
Salary deferrals	$200,000
Total	$500,000

Gracie's has a total of $50,000 in her after-tax account, which the plan has separately tracked. She wants to convert and roll over the amount to a Roth and traditional IRA in the most tax-efficient way possible. She requests a distribution of her after-tax account ($50,000). Following Notice 2014-54, she instructs the plan administrator to directly roll over the pre-tax amount ($5,000 of earnings) to her traditional IRA and convert the after-tax amount ($45,000 of contributions) to a Roth IRA. Gracie's tax reporting will reflect a $5,000 tax-free traditional IRA direct rollover and a $45,000 tax-free Roth IRA conversion (reported on her IRS Forms 1040 and 8606). Alternatively, if Gracie had converted the entire amount withdrawn to a Roth IRA alone, she would have to include the $5,000 of earnings in her taxable income for the year.

How is an in-plan conversion to a designated Roth account accomplished?

The amount that a plan participant can contribute annually as a designated Roth contribution is limited. For 2022 the combined total of pre-tax salary deferrals and designated Roth contributions cannot exceed $20,500 for participants under age 50 and $27,000 for those ages 50 or older. Another method of acquiring designated Roth contributions in a 401(k) plan is through an in-plan conversion. Plan document language will specify whether this is an option; and after-tax account balances can allow participants to take advantage of low or no tax impact in-plan conversions.

In-plan conversions must be completed as a direct rollover within the plan to a designated Roth account. Participants who complete in-plan conversions must include the taxable portion of their conversions in income for the year under the standard conversion taxation rules. Because of the pre-1987 grandfather/post-1986 basis recovery rules discussed previously, an in-plan conversion of a participant's after-tax account to a designated Roth account is another tax-efficient way to acquire Roth assets.

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When might a 401(k) after-tax contribution strategy be a good fit?

Whether a plan participant has the ability to make after-tax contributions to a 401(k) plan depends on the governing language of the plan. In order to determine whether a participant has an after-tax contribution option in a 401(k) plan, he or she can check with the benefits administrator or review the plan document or summary plan description for the plan. If the participant discovers that an after-tax contributions option exists, he or she should consider several key questions:

- Does the plan account for and track the amounts separately from other contribution types?
- Should the participant contribute to the plan on an after-tax basis, and if so, how much?
- When does the plan allow for distributions of the after-tax account balance?
- Should the participant consider a withdrawal, rollover or conversion of the after-tax account balance?
- What would the tax implications be in each scenario?

Working with a team of tax and financial professionals who can offer insight and guidance can help a plan participant feel more confident that he or she is answering these questions in a prudent manner with an eye on the big financial picture and future.

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